

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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LEGEND

- Taxpayer =
- Trust =
- Company =
- Bank =
- Year 1 =
- Year 2 =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- \$a =
- \$b =
- \$c =
- \$d =
- s% =
- t% =
- u% =
- m =
- n =
- p =

Dear _____ :

This is in reply to a letter submitted by your authorized representative requesting a private letter ruling under § 453 of the Internal Revenue Code. Specifically, Taxpayer requests a ruling that the modification of an installment sales obligation by deferring the maturity date, substituting a new obligor, and altering the interest rate is not a disposition or satisfaction of the installment obligation within the meaning of § 453B.

FACTS

Taxpayer, an individual, files its return on a calendar year basis, uses the cash method of accounting, and, as a former shareholder, was engaged in the business of providing business solutions to federal, state and commercial customers, including professional consulting, and technical support services. The transaction described below was entered into by Taxpayer's revocable grantor trust (Trust). Taxpayer is the trustee of Trust, and Taxpayer reports all Trust income.

In Year 1, Company completed a transaction (the "Original Transaction") in which: (i) Company adopted an employee stock ownership plan, which included an employee stock ownership trust (together referred to as the "ESOP"); (ii) Company facilitated the ESOP's purchase of all the outstanding stock of Company from the former shareholders, including Taxpayer; and (iii) the parties to the Original Transaction entered into certain financial arrangements including: (a) Company borrowing \$a in senior financing from Bank (the "Bank Loan"); (b) Company lending \$a to the ESOP to purchase a portion of the shares from the former shareholders (the "Company Loan"); and (c) the ESOP borrowing an aggregate of \$b from the former shareholders in the form of notes to pay the balance of the purchase price (the "ESOP Loan").

As part of the Original Transaction, Taxpayer received a promissory note from the ESOP in the principal amount of \$c (the "Note"), which represents Taxpayer's portion of the ESOP Loan. The Note provides for annual interest at the rate of s% and monthly payments of interest only for the first two years and monthly payments of principal and interest for a period of m years. The entire unpaid principal balance together with all accrued unpaid interest is due on Date 1, n years after the ESOP issued the Note. As security for payment of the Note, Company absolutely, unconditionally, and irrevocably guaranteed the ESOP's obligations on the Note, and the ESOP pledged the stock it purchased from Taxpayer to Taxpayer. Taxpayer did not elect out of installment sale treatment and is reporting gain realized from the sale of the shares of Company stock on the installment method under § 453 of the Code. As of Date 2, there is \$d in principal and accrued interest outstanding on the Note.

In Year 2, Company and Bank entered into certain amendments to the Bank Loan to address Company's deteriorated financial condition and to provide for revised payment schedules on the Bank Loan, the Company Loan, and the ESOP Loan, including the Note, as well as to establish amended financial covenants for Company. Company, ESOP, and the shareholders have agreed to make changes to the Company Loan and the ESOP Loan to satisfy required Bank amendments and to permit Company to repay all of its debts on a reasonable schedule that will permit Company to operate using available cash flow and also within applicable legal requirements relating to the ESOP.

Company proposes to complete a transaction (the “Proposed Transaction”) based on the required Bank amendments in which: (i) the shareholders will deliver to Company, and Company will assume, the notes and pledge agreements that the shareholders are holding from the ESOP as part of the ESOP Loan, including Taxpayer delivering the Note to Company; (ii) Company will modify the payment terms of the notes it assumes, including the Note, and will set forth the modified terms in a new note to be delivered by Company to Taxpayer (the “New Note”); and (iii) in consideration of Company assuming the Note and issuing the New Note, the ESOP will deliver to Company a note with a principal amount equal to the amount currently outstanding on the ESOP Loan. The note restructuring will provide Company greater cash flow flexibility without significantly changing the benefit stream to the ESOP participants.

As a result of the Proposed Transaction, and in accordance with the terms of the New Note, the maturity date of the Note will be deferred, the obligor will be substituted, and the interest rate will be altered. Instead of the entire unpaid principal balance together with all accrued unpaid interest being due on Date 1, the Note will be restructured to provide for monthly payments of interest at the annual rate of $t\%$ until Date 3, and amortized monthly payments of principal and interest at the annual rate of $u\%$ amortized over a period of p years with the entire unpaid balance together with all accrued unpaid interest being due on Date 4. In addition, as a result of the Proposed Transaction, instead of the ESOP being the obligor on the Note, Company, currently the guarantor on the Note, will be substituted as the direct obligor. In all other respects, the terms of the Note will remain unchanged.

Taxpayer requests a ruling that the modification of the terms of the Note by deferring the maturity date, substituting a new obligor, and altering the interest rate is not a disposition or satisfaction of an installment obligation within the meaning of § 453B of the Code.

LAW & ANALYSIS

Section 453 of the Code provides that income from an installment sale shall be taken into account under the installment method. Under the installment method, a portion of the total gross profit from an installment sale is included in income in each year in which the seller receives payment.

Section 453B(a) of the Code provides that if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange. In short, if an installment obligation is satisfied at

its face value or if it is “distributed, transmitted, sold, or otherwise disposed of,” the seller must recognize gain or loss at that time.

The Internal Revenue Service has held that certain modifications of the terms of an installment obligation are not a disposition or satisfaction of the obligation. In Rev. Rul. 68-419, 1968-2 C.B. 196, the parties agreed to modify the terms of a note so that each installment of principal due by the original terms of the note would be deferred for a period of five years. In addition, the rate of interest was increased from six percent to seven percent per annum. Rev. Rul. 68-419 holds that “the modification of the terms of a purchaser’s note (by deferring the dates of payment of principal and increasing the rate of interest) is not a disposition or satisfaction of an installment obligation” within the meaning of § 453(d), the predecessor of current § 453B. See, also, Rev. Rul. 55-429, 1955-2 C.B. 252, reaching similar results.

In Rev. Rul. 75-457, 1975-2 C.B. 196, a taxpayer sold real estate to an individual for cash, a deed of trust, and a promissory note providing for monthly payments over a 15-year term. The terms of the deed and note allowed the individual to resell the property, provided that the subsequent buyer executed a new note under the same terms and conditions as the original deed of trust. The original obligor subsequently sold the property to a successor individual who assumed the obligation by executing a new deed of trust and note in favor of the taxpayer under the same terms and conditions as the original deed of trust and note. The original obligor was released from liability on the original note. Rev. Rul. 75-457 holds that the substitution of obligors, deeds of trust, and promissory notes, without any other changes, is not a satisfaction or disposition of an installment obligation under § 453(d) of the Code. Likewise Rev. Rul. 82-122, 1982-1 C.B. 80, holds that the substitution of a new obligor and a change in the rate of interest is not a satisfaction or disposition of an installment obligation for purposes of § 453B(a).

To summarize the revenue rulings, modification of an installment obligation by deferring the maturity date, substituting a new obligor, and altering the interest rate is not a disposition or satisfaction of an installment obligation for purposes of the installment sales provisions under § 453B. Moreover, where the original installment note is replaced, the substitution of a new promissory note without any other changes is not a disposition of the original installment note under § 453B.

CONCLUSION

Based upon the facts and representations presented and the above analysis, we conclude that the described modification of the terms of the Note by deferring the maturity date, substituting a new obligor, and altering the interest rate is not a disposition or satisfaction of an installment obligation within the meaning of § 453B of the Code.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Donna J. Welsh
Senior Technician Reviewer, Branch 4
(Income Tax & Accounting)

cc: